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DOW THEORY LETTERS

"The Market as Interpreted under the Dow Theory"

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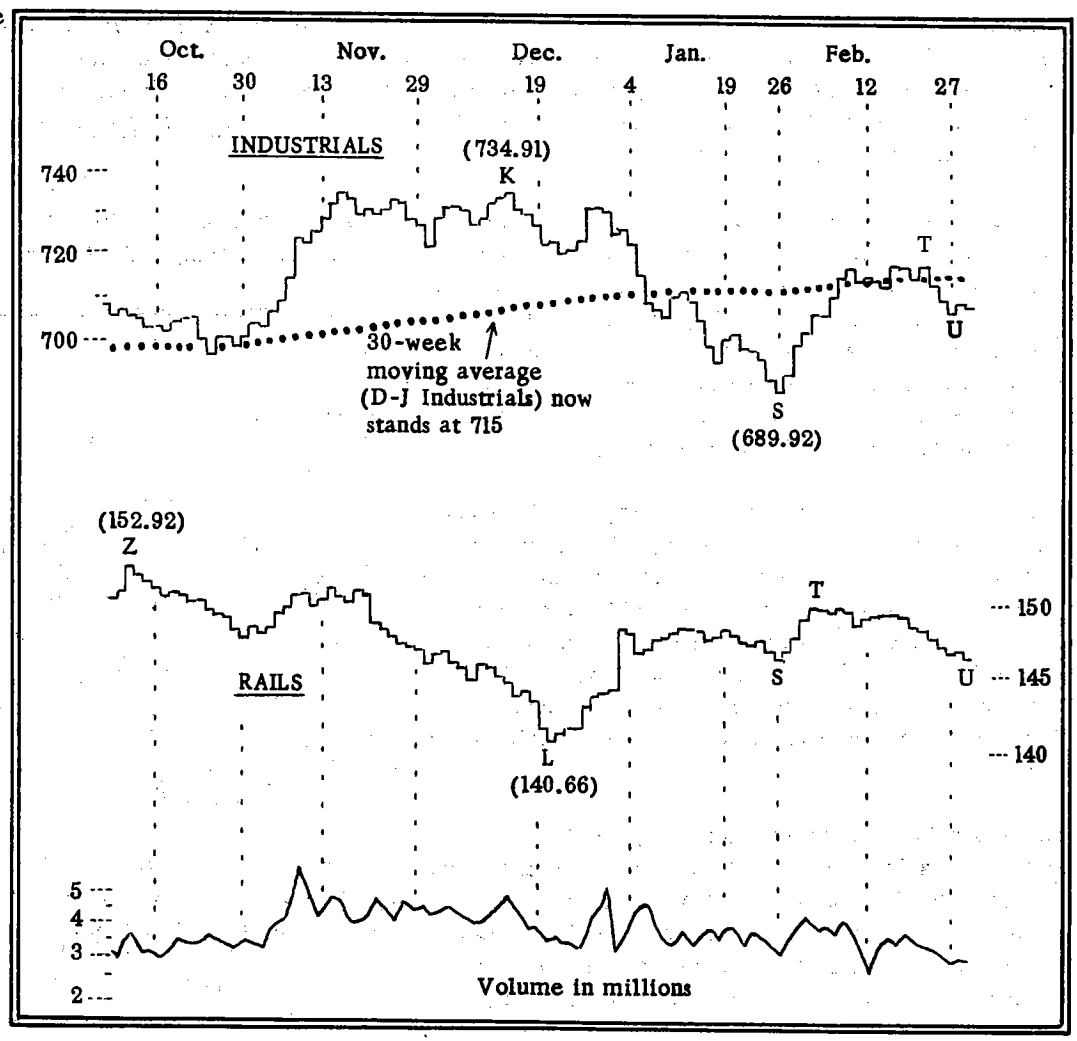
THE MARKET As described in the last Letter, the rally from S to T provided a lackluster performance. Upside volume "peaked" on February 1 (halfway through the rally), Rails recorded their best prices on February 2, and new highs refused (during the entire rally) to expand beyond a five-day average of 39. By the time Industrials struck their peak day at T (see chart), Rails were already showing signs of "rolling over".

Although it has not always been true, over the last few years Rails have tended to be the "bellweather" of the market (as far as direction is concerned). Thus in October, 1960, it was the Rails which would not confirm the final Industrial low. Furthermore, since March, 1961, Rails have repeatedly served notice that the market was stalling or running into trouble.

Referring to the recent S-T rally, the Rails recorded their peak on February 2 (just four trading days from the low at S). Thereafter, Rails worked steadily lower, but despite this, Industrials continued their rally to February 20 (T). In the face of the continuing Rail divergence, however, Industrials gave up the fight, and (on February 21) they too turned down.

On the decline from T volume contracted steadily, and at U volume dropped to 2.9 million shares, the second lowest volume of the year. If the rally to T developed no buying power (as represented by volume) neither did the decline to U generate any selling pressure. All of which underscores the nature of the general market stalemate (a stalemate which has been commented upon so many times in recent Letters).



There have been a number of comparable "stalemates" or trading ranges during bull markets of the past. In the majority of cases, before prices could be definitely resolved to the upside, one of the following two phenomena occurred: (1) Increasing pessimism was generated, and in the face of this pessimism one or both Averages held above their preceding lows.

(2) A final decline to new lows served to arouse great fear (and/or that conditions known as a "sold-out" market.)

Informed investors like to do their buying under the most favorable conditions. This means buying after an important decline or buying when the public is selling. The above conditions fit one or both of these prerequisites.

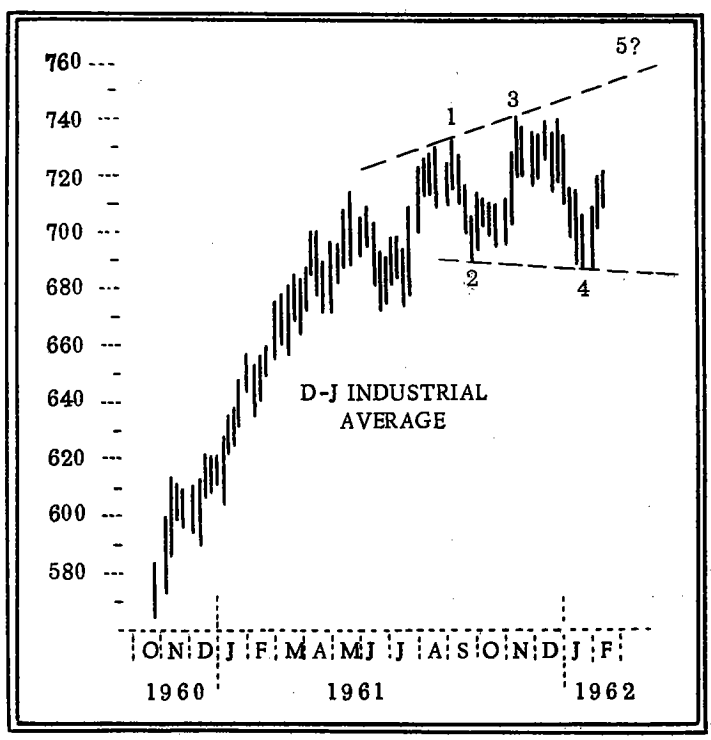
Over the past few weeks, the odd-lotters have switched to the selling side of the market, and this is, of course, comforting to the large investor. When the odd-lotter sells more than he buys the market is gathering technical strength. If the current odd-lot selling continues, there is a fair chance that the market may already have seen its lows at S. It is my opinion, however, that a much more favorable buying area will be produced if, in the face of odd-lot selling, the market goes into a final "cleanout" decline. Such a decline might result in one Average's breaking the recent lows while the other refuses to confirm. In the present circumstances, the lows in question are S (689.92) on Industrials and L (140.66) on Rails. As mentioned before, this writer would prefer to see the July (679.30) Industrial low broken (while the July-133.49 - Rail low holds intact).

FORMATIONS Chart "formations", as applied to the Averages, play no part in classic Dow Theory. For this reason, I usually confine discussions of chart formations or patterns to the section on individual stocks (at the end of each Letter). Moreover, it has been my experience that readers (particularly neophytes) are prone to "discover" a new formation with each successive minor movement of the Averages.

On rare occasions, however, these Letters do call attention to interesting chart formations as they may occur in one or both Averages. And developments over the past six months lead me to believe that such a discussion is again warranted. The following analysis assumes a particular significance in view of opinions which were expressed in Letter 170 -- namely, (1) that an Industrial advance from this area to new all-time highs would probably not be confirmed by the advance-decline ratio, and (2) that such a rise and possible non-confirmation could easily lead to major divergence (between the advance-decline ratio and the Industrial Average) and a subsequent severe reaction or bear market.

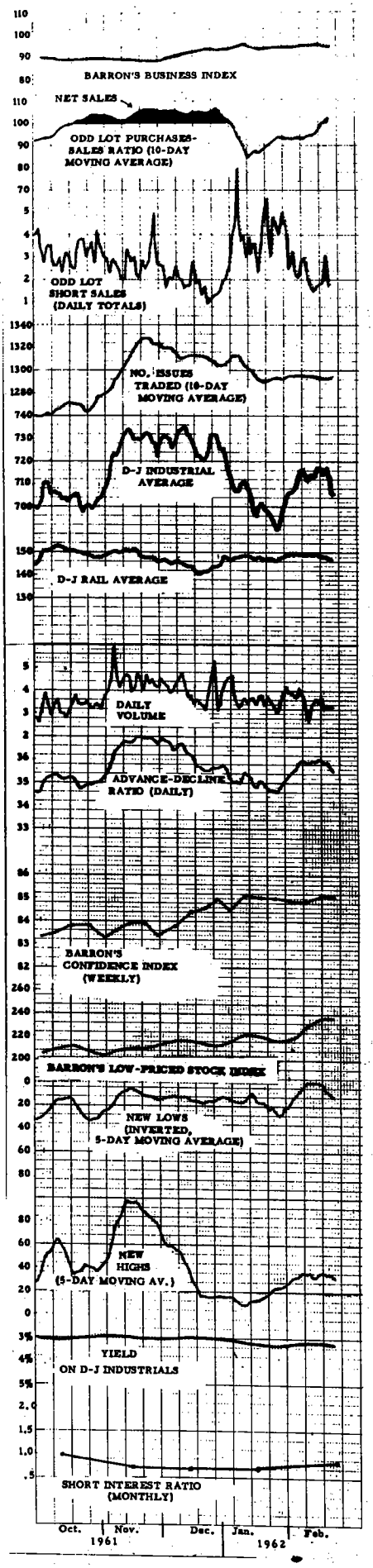
Referring to the chart on this page, note that the September high and low on the Industrial Average (points 1 and 2) taken together with the December high and January low (points 3 and 4) form a definite four-point reversal pattern. This structure, as it has been developing, may well be part of a "broadening formation". For the benefit of newer readers, I will reiterate that a broadening formation (or broadening top) is essentially a five-point reversal pattern with each peak higher than the previous peak and each low under the preceding low.

A broadening top has been completed only once in the history of the Industrial Average (in 1957, prior to the 100 point drop which occurred in the latter part of that year.) Broadening tops were seen on many individual stocks in 1929, and since that time, these formations have always been associated (in the minds of chartists) with severe collapses. Actually, the great majority of broadening formations do hold bearish connotations; they are a product of a "churning", aimless, crowd-dominated market -- a market which can not make up its mind which direction to take.



If the current structure is to result in a completed broadening formation, then the Industrial advance (which started in January from point 4) should be expected to continue to point 5 (which comes at approximately the 750-60 area -- see chart). From point 5, a broad decline would be expected to take Industrials back to the lower trendline (at about 680). A penetration of the lower trendline would then complete the broadening top and open the way for substantially lower prices.

A few readers have called attention to a potential "head-and-shoulder" formation in the Industrial Average. If the current rise (from point 4) is considered to be the "right shoulder", there is no doubt that the recent structure also bears a resemblence to an incompleted head-and-shoulder pattern. A decline from this area to a level under the "neckline"



(below the lower dashed trendline) would serve to complete the head-and-shoulders reversal pattern (in which case the broadening pattern would obviously not have materialized).

All of which presents a more dynamic picture than might otherwise be indicated by the seemingly tedious daily movements of the past few months.

INDICATORS Significant changes in the important indicators are listed as follows: (1) Barron's Business Index, having hit a high of 94.9 on January 15, has leveled off and held under that figure for six consecutive weeks. (2) The advance-decline ratio kept pace with the Industrial Average on the January-February rise, but it is still far from either its November peak or its (higher) May, 1961 peak. (3) The Confidence Index has been confined to a remarkably narrow range for seven consecutive weeks. (4) The five-day average of new highs has dropped under 30, while new lows have expanded to a five-day average of 16. (5) Barron's Low-Priced Stock Index rose to a high of 236 last week. This is the highest level since March, 1959, and the rise suggests a possible reawakening of speculative interest. (6) The latest short interest ratio is .87, a slight improvement over the last three months, but anything under 1.0 must be considered neutral to negative on this indicator. (7) The brightest spot in the technical picture is the odd-lot trading. In early January, odd-lotters decreased their buying, and that trend has continued until the past few weeks showed a switch to actual selling.

SUNDRY COMMENTS The public is being made increasingly aware of the rate war among savings institutions. In the last month I have read perhaps a dozen articles pertaining to the new 4 to 4.7% rates among thrift institutions, the latest being the article in the February 24 issue of Business Week. There is no doubt that interest rates of 4% and above are attractive to "battle-weary" stockholders. Certainly, in a market which has been in a "trading range" for almost a year, the prospect of a worry-free 4% at the local savings bank has its allure, particularly where new money is concerned. As a rule, important money will go into Wall Street when it is felt that trading profits and capital gains are a reasonable expectation. The public is never attracted by values; it is seldom attracted by a substantial decline. The one thing that is sure to bring in the public is a steadily climbing market.

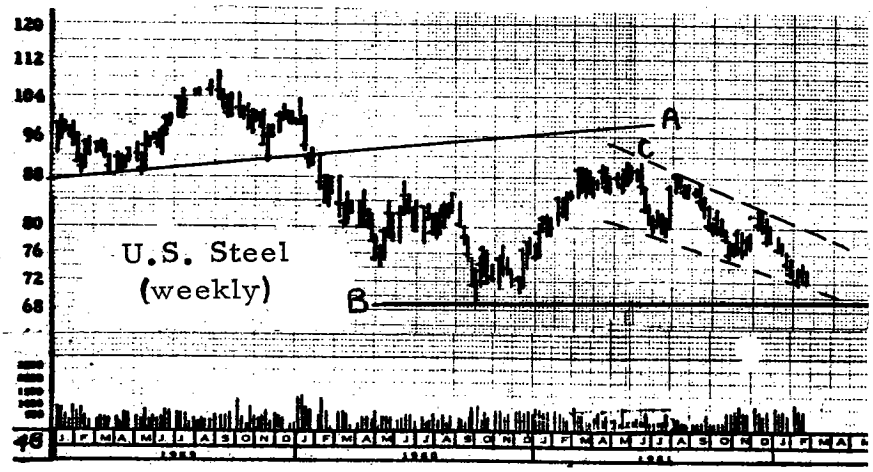
For eleven months the public has watched a trendless affair. It is only natural that increased savings rates (particularly when they are given such wide publicity) should siphon off an increased share of available funds. The figure of 5% has had a magic appeal to the public in the past. If the West Coast Savings and Loan outfits are forced to go to 5% (as seems possible), the battle for money will become even more "cut-throat".

STOCKS Twenty of our 56 "key" stocks are now above their moving average. This is a drop of four from last week.

Many subscribers have written to ask me whether I prefer daily or weekly charts of individual stock action. The answer is that I prefer working broadly with weekly charts. Then, when a stock looks particularly interesting on a long-term (weekly) basis, I will refer to the daily chart.

Litton Industries provides a good current example. On the weekly, we can see that the long trendline which extends through the 1960 and 1961 lows was broken in late 1961. Despite this, the stock ran up to a new high, faltered

again at the trendline, then turned sharply lower. The penetration of a long-term weekly trendline is often the first hint of trouble ahead. What the stock does following the penetration may provide the clue as to whether the stock is going to react mildly or whether the stock is in for a major reversal. More often than not, I have found that the penetration of a major trendline (at best) leads the way to a long consolidation. At other times, it marks the beginning or a bearish formation and a later "topping out" of the issue.

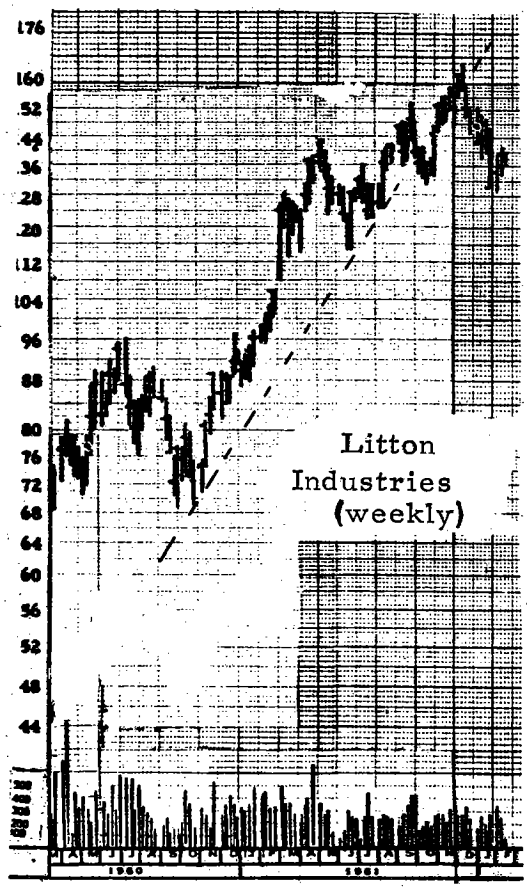


The daily chart shows the action of Litton since July of last year. Here we see what appears to be a large "head-and-shoulders" distribution pattern with volume dropping progressively (in classic style) through the left shoulder, the head and the right shoulder. A final penetration of the "neckline" (solid black line) at about the 128 level would mean that the head-and-shoulders pattern was completed.

Often, following the neckline penetration, there will be a rally or "pull-back" to the neckline. If this is accomplished on very light volume, it usually means that the stock is in an ideal shorting position.

Many traders prefer to short a stock as it rounds over (on low volume) at the top of the right shoulder, and I see nothing wrong with this procedure.

Another observation worth noting: often a stock such as Litton will be saved at the critical point by a strong surge in the general market. Thus a violently rallying market might take Litton back to the top of the right shoulder prior to penetration of the 128 level. Nevertheless, when a stock gets in the position which Litton is now in, the odds favor the seller and the short seller. The next week or two should provide a critical test of the strength or weakness of Litton.



Mighty U. S Steel presents a fascinating story, a story which can only be seen on the weekly charts. Having broken below the neckline (A) of a great head-and-shoulders pattern in 1960, Steel touched a low (B) of 69 1/4 in 1960. The rally to C halted in the supply area of the trendline A. During 1961, Steel made three downward thrusts within a descending channel. This has taken the stock to the low of the channel and just above the 1960 low at B. Steel should show important downside resistance in the current area of 69-71. Purchases might be made here on the basis of what should be strong support and limited downside risk in the current area (it should be sold on a close of 68). There is also the possibility of a technical rally to at least the upper limits of the channel -- at about 80.